United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

ORIGINAL

76-7528

To be argued by
ROBERT A. BICKS

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P/S

United States Court of Appeals
FOR THE SECOND CIRCUIT

UNITED STATES STEEL AND CARNEGIE PENSION FUND, INC., CONNECTICUT MUTUAL LIFE INSURANCE COMPANY, and THE NATIONAL BANK OF COMMERCE OF DALLAS (AS TRUSTEE OF THE OMEGA-ALPHA, INC. POOL TRUST),
Plaintiffs-Appellants,

—against—

HENRY ORENSTEIN, FIRST NATIONAL CITY BANK, HAYDEN STONE INC., BERNSTEIN-MACAULAY, INC., ROGER S. BERLIND, and SANFORD I. WEILL,
Defendants,

—and—

FIRST NATIONAL CITY BANK,
Defendant-Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

REPLY BRIEF OF PLAINTIFFS-APPELLANTS

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United States Steel and Carnegie Pension Fund, Inc., Connecticut Mutual Life Insurance Company, and the National Bank of Commerce of Dallas (As Trustee of the Omega-Alpha, Inc. Pool Trust),

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Citibank's Position

With plaintiffs' and Citibank's briefs lodged, Citibank's defenses boil down to the arguments:[1]

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[1] Citibank also argues that there were no special circumstances or relationships giving rise to an affirmative duty of disclosure (*Appellee's Brief* at 32-38). While the five factors relied upon by plaintiffs in asserting that such a duty existed under the facts at bar are treated in Appellants'

- That in making their Topper investment, neither the Pension Fund nor Connecticut Mutual relied, nor should have relied, on what Citibank labels a "five-minute" credit inquiry or a "routine credit check" rendered by Citibank's Waldman to the Pension Fund;

- That as of August 27, 1971, the date of Waldman's favorable report to the Pension Fund, Topper's business and financial condition was not really all that bad;

Brief (at 32-38), the authority cited by Citibank to gainsay a duty deserves comment since these same factors are to a significant extent absent in each case relied upon by the defendant. Initially, *Lanza* v. *Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973) involved an outside director who never undertook to provide plaintiffs with information, received no benefit from the transaction at issue, played no substantial role in requiring or effecting the transaction, and had no special relationship with the investors. *Id.* at 1284-89. *City National Bank* v. *Vanderboom*, 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970) was a summary judgment case in favor of a bank that simply loaned funds to certain counter-claiming defendants who then used the funds to purchase the securities. The counter-claims were dismissed for lack of standing under the "in connection with" requirement. Moreover, the bank itself in *Vanderboom*, as distinct from its officer who allegedly participated in the fraudulent scheme and was acting outside the scope of his authority, 422 F.2d at 231, never undertook to provide information to the investors, possessed no inside information on the issuer other than routine financial statements of the company, received no financial benefit from the sale of the securities, and had no special relationship with the counter-claiming defendants. *Woodward* v. *Metro Bank*, 522 F.2d 84 (5th Cir. 1975) was an aiding and abetting case brought against a bank that never undertook to provide financial information to the plaintiff, *id.* at 98, provided no favorable report on the issuer's financial condition, *id.*, received no proceeds from the transaction, *id.* at 99-100, had insufficient information on the issuer "to make an informed decision on [its] solidity," *id.* at 98, had no investing stake in the issuer, *id.* at 94, and had no special relationship with the plaintiff. *Id.* at 88. Finally, *Grimes, Hooper & Messer, Inc.* v. *Pierce*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,341, at 98,693 (C.D. Cal. 1973), *aff'd*, 519 F.2d 1089 (9th Cir. 1975), was another aiding and abetting case against a bank whose employee had casually commented on the personal integrity of a securities broker but who never undertook to provide financial information on the broker, *id.* at 98,692, indeed possessed no such inside information, *id.* at 98,693, received no benefit from the transaction (other than a $5 transfer fee), *id.*, and had no special relationship with the plaintiff. *Id.* at 98,962.

- That whatever information the Pension Fund sought from Citibank, the Pension Fund might elsewhere have unearthed by itself compiling, distilling and analyzing Topper's voluminous computerized print-outs; and

- That even if Topper was on the brink of financial disaster in the summer of 1971 and Citibank knew of its plight, *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976) nonetheless saves Citibank from Section 10(b) of the Securities Exchange Act of 1934 because the District Court believed Waldman acted in "good faith."

I.

Contrary to Citibank's Claims, the District Court Found That the Pension Fund Sought and Received From Citibank a Favorable Report on Topper's Financial Condition on Which Both the Pension Fund and Connecticut Mutual Relied.

A. The Pension Fund Sought Information From Citibank Concerning Topper's Financial Condition and Not Simply a "Credit Check" on Topper's Payable Record

Argumentative labels such as "credit check" or "routine credit inquiry" aside, the Pension Fund's purpose in approaching, and the nature of its inquiry to, Citibank are spelled out by the District Court's findings below, not one of which is challenged on appeal by Citibank. Initially, plaintiffs knew of Topper's

> "close working relationship with Citibank, which received the voluminous financial reports prepared by Topper on a daily and monthly basis, including particularly reports relating to collections and receivables. . . . Both plaintiffs were told by Topper management that they were free to speak to Citibank 'to get information about Topper's financial condition' " (Fdg P18).

> "Because it had not independently verified '"the company's current financial condition"' . . ., the Pension Fund, which also enjoyed an investment advisory agreement with Citibank, decided such an inquiry to Citibank was appropriate" (Fdg P19).

Further, the District Court's findings make no bones about just what the Pension Fund wanted from Citibank:

> "Approaching Citibank in connection with the Private Placement, *the Pension Fund wanted all material information relating to Topper's current financial condition that would be useful in evaluating whether to proceed with the purchase of Topper securities . . . a fact which Citibank does not dispute.* . . . [T]he Pension Fund
>
> > 'wanted to know from the bank . . . [which] was in a position to follow the company on a day-to-day basis, whether the company was in good financial condition as of that date, and whether the bank saw any clouds on the horizon'" (Fdg P299) (emphasis added).

B. Citibank Knew That the Pension Fund Wanted All Material Information Relating to Topper's Current Financial Condition

As a first step, Thompson of the Pension Fund approached Citibank's Jeffers, the liaison between Citibank and the Pension Fund (A1672). Thompson told Jeffers

> "that [the Pension Fund was] considering making an investment in Topper convertible debentures. . . .
>
> "I then told him that . . . I had questioned the Company about its banking relationship and with particular emphasis on the accounts receivable and inventories and had been told that Citibank was the lead bank in the lending group for the company. And then I asked him for whatever help the bank could give us

in evaluating whether to make an investment in Topper" (A622-A623).[2]

Because Jeffers had no knowledge of Topper, he contacted his fellow Citibank officer Waldman, whom Jeffers knew had overall responsibility for the Topper account, and asked Waldman to call Thompson (Fdg P305). "In response to Mr. Jeffers' request Mr. Waldman, telephoned Mr. Thompson of the Pension Fund on the afternoon of August 27, 1971" (Fdg P306).

By that time, Waldman was not in the dark as to what Thompson wanted:

> "At the time he telephoned Mr. Thompson, Waldman knew that Thompson 'represented the Pension Fund' (*Waldman Tr.* 1258-59); 'the Pension Fund was considering purchase of the Topper debenture[s]' (*id.*); 'the debentures were to be unsecured' (*id.* at 1253); there existed 'a relationship on the part of U.S. Steel with the bank' (*id.* at 1258); and that Thompson 'wanted all the information necessary' to evaluate the Private Placement (*id.* at 1254-55, 1259)" (Fdg P307).

C. Waldman's Report to Thompson Was an Event Without Precedent for Waldman

True, Citibank officers did testify that from time to time they received "credit inquiries made to the bank concerning Topper" (A1166), such as from "an automobile leasing company" interested in Topper's payable record (A1166, A1281-A1282).[3] Equally true, however, and just contrary

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[2] The District Court adopted this finding at the conclusion of trial:

"I have found that it happened just the way it has been testified to. That is one finding that I have committed myself to make. It happened just the way Thompson described it. . . . It is what I find now, what I will find, that that is exactly what Thompson told Jeffers" (A1569; *see* A23 n.4).

[3] A favorable report to a trade creditor would have been equally misleading under the circumstances, since an August 9, 1971 Citibank audit

to Citibank's effort to portray Waldman's report as routine, Waldman acknowledged that prior to the occasion at bar he had never been asked to supply information concerning Topper or any other company to a potential investor. As the District Court found:

> "Although Waldman and other officers testified that they had previously responded to various 'credit checks' from various third parties, he acknowledged that prior to the Thompson conversation on August 27, 1971, he had never been asked by Mr. Jeffers or any other senior bank officer outside his department to supply information concerning Topper or other accounts to a prospective investor" (Fdg P319) (footnote omitted).

D. Citibank Rendered the Pension Fund a Favorable Report on Topper's Then-Current Financial Condition

Contrary to Citibank's assertion that "[t]he Court found that there was no discussion of financial condition or whether there were any problems in connection therewith" (*Appellee's Brief* at 26), the District Court found:

> "[T]he senior Citibank officer responsible for the Topper account called the Pension Fund on August 27, 1971 and gave a favorable report on Topper's current financial condition. Among other things, Citibank represented to the Pension Fund that Topper had performed well in a Citibank audit of its receivables, that Topper's principal product line was faring well at retail, that there were no current problems with the Topper account and that Citibank anticipated none" (Fdg P20) (footnote omitted).

Confirming this, the Court further found that "Waldman subsequently indicated to two Citibank officials that he had

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report found that 35% of Topper's accounts payable were "delinquent" and, more importantly, Citibank officers were informed that the reason for this delinquency was because "they simply don't have funds" (A3227).

given Thompson a favorable report during the course of their August 27, 1971 conversation" (Fdg P320) and that "[a]t no time during any one of the four meetings" between the parties in 1972 did any Citibank official disagree " 'that Waldman had given the Pension Fund a favorable report on Topper's financial condition' " (Fdg P321).

E. The District Court Found That Both the Pension Fund and Connecticut Mutual Relied on Citibank's Favorable Report

Similarly at odds with the findings of fact below is Citibank's claim that the Pension Fund failed to rely on Waldman's favorable report on Topper's financial condition. Thus the Court concluded:

> "Both the Pension Fund and Connecticut Mutual in fact relied on Citibank's favorable report on Topper's current financial condition in connection with their decision to participate in the Private Placement" (Fdg P22).

This finding rests upon the 20 year relationship between the parties (Fdg D269), Citibank's practice of providing reliable information in connection with prior private placements (Fdgs D276-D279), Citibank's inside position as lead commercial banker to Topper (Fdgs P18, P48), and the undisputed testimony of the Pension Fund's President at trial.[4] In this context, plaintiffs' reliance was plainly reasonable and meets the "substantial cause" test of *Herzfeld* v. *Laventhol, Krekstein, Horwath & Horwath*, 540 F.2d 27, 34 (2d Cir. 1976).

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[4] Harvey Mole, President of the Pension Fund, testified that: *"I felt that this was probably the most important check we could have gotten on Topper* because of the Citibank's position as lead bank, the fact that they were lending them money, and, most of all, because unlike many other banks, we had an investment relationship with them which extended over approximately twenty years, and we had done this same sort of thing many times before, as I cited, with only one case where they were not sufficiently up to date . . . . *If we had gotten a poor check from the bank, I think it is extremely doubtful that we would have gone ahead"* (A855-A856) (emphasis added).

II.

In the Summer of 1971, Topper's Condition Was Plagued by "Several and Severe Financial Problems".

Citibank's efforts to gloss over Topper's financial difficulties in 1971 are equally misplaced. There were, as the District Court found, "several and severe financial problems" at Topper in the areas of collections, receivables and loan availability (Fdg P193).

A. Collections

While "Topper's performance in meeting its projected collections was always sporadic" (*Appellee's Brief* at 11), the District Court found that "prior to the end of 1970 [cash] shortfalls were generally insignificant, typically amounting to less than $500,000," lasted for a "limited duration," were "collateralized by eligible receivables," and "recovered within a month" (Fdg P250). In contrast, the Court concluded the "$10 million cash shortfall which occurred during the critical months of May through September . . . was completely without precedent in the Topper account" (Fdg P254). Citibank's Mr. Lusk himself acknowledged that "never once during the four year period 1968 through 1971 was there a comparable 'period when Topper had had a shortfall from projections of $10 million in cash'" (*id.*).

B. Receivables

So, too, for Citibank's attempts to downplay the deterioration in Topper's receivables,[5] which the District Court

[5] In support of its position that the deterioration in Topper's receivables was not all that bad (*Appellee's Brief* at 13), Citibank simply lifts the unadjusted receivable data from its advance sheets without accounting for substantial inconsistencies in the data. Thus figures drawn from Citibank's advance sheets relating to the percentage of ineligible receivables in 1971:

(a) treat $2 million in redated receivables as ineligible from April 13, 1971 through June 1, 1971 but thereafter treat the same receiv-

described as "precipitous" (A24) and found to be "'a definite indication of a problem'" at Topper (Fdg P180).[6] By the end of August 1971, past due receivables were five times the amount outstanding for the comparable period in 1970, fourteen times as great as in 1969 (Fdg P258), and so many were past due or ineligible that Price Waterhouse and the Court concluded that Topper's net worth was in jeopardy (Fdg P184). As for Citibank's claim that "past due accounts had not become bad debts" in prior years (*Appellee's Brief* at 11), this was only because Topper, as Citibank well knew (Fdgs P97-P106), uniformly credited such accounts when its major customers were unable to sell their Topper merchandise at retail (Fdgs P78-P90).[7] Small wonder the accounts never went bad. By the summer of 1971, the District Court found, Citibank knew that "the

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ables as eligible even though there was no change in their collectability or collateral value (Note 1 to PX 1441 at A171);

(b) treat $10.8 million in so-called Drop Ship receivables as ineligible in January and February and $1.4 million in March, even though the same receivables were subsequently deemed eligible by Citibank beginning in March (*id.* n.2); and

(c) treat $2 million in receivables attributable to the August portion of the Spring 1971 Program as ineligible for the months of January and February, but as eligible thereafter (*id.*).

"[T]o show a consistent presentation of the data for the period involved" as well as "to show the economic realities of the situation" (A986), Price Waterhouse & Company adjusted the data to present a consistent picture of Topper's receivable history at trial. The assumptions underlying this presentation were not challenged on cross-examination and were subsequently adopted by the District Court in its findings (*see* Fdg P264).

[6] The Citibank officer responsible for the Topper account, Mr. Siegel, acknowledged under oath that the high percentage of past due receivables in the summer of 1971 "represents obviously not a good picture" and reflected what he "would consider [was] a serious condition" (A1327).

[7] Although Citibank disclaims knowledge of certain letter agreements explicitly granting customers various concessions with respect to the Spring 1971 Program, the substantive concessions offered in these letters had long been granted by Topper informally and as a matter of business practice (Fdgs P57-P76), as customer testimony at trial confirmed (A478-A479, A561) and as Citibank well knew (Fdgs P90, P93-P106).

amount of outstanding credits issued by Topper . . . was 'substantial' viewed against both collections and sales" (Fdg P263).

C. Over-Advances Were Required to Keep Topper in Business Until the Private Placement

Finally, Citibank seeks to understate the significance of the substantial over-advances[8] granted Topper prior to the Private Placement (*Appellee's Brief* at 6-7), even though the trial court found the "adverse nature of the $5 million over-advance outstanding on August 27, 1971 [was] likewise clear" (Fdg P269). At the outset, it was Citibank's own internal memoranda which, on February 23, 1971, limited the amount of permissible over-advances to Topper after May 1971 to *no more than $500,000* above eligible receivables[9] (Fdg P242). Topper's financial fortunes declined to such an extent during Summer 1971, though, that Citibank on three occasions was forced to go beyond its own advance instructions[10] and grant over-advances, or bridge loans, the last of which occurred two days before Waldman's call and was *ten times* greater than

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[8] The District Court found that "'[o]ver-advances [are] an unsecured loan, in effect' . . . and thus 'a matter of concern to a secured lender'" (Fdg P243). Citibank, as other lending institutions, maintains the practice of preparing "advance instructions . . . to enable the bank to determine, for any period of time during the year, the permissible extent that outstanding loans may exceed the value of present collateral" (Fdg P244).

[9] The District Court found that "[a]lthough Citibank held a secured interest in all principal assets of Topper under the Finance Agreement . . . Citibank advances in 1971 were based solely upon 'eligible accounts receivable'" (Fdg P245) and that "Citibank stopped advancing funds against non-receivable collateral at the end of September 1970," because Topper at that time transferred its manufacturing operations to the Orient (Fdg P246).

[10] Citibank agreed to these over-advances despite the fact that the officer in charge of the Topper account on a daily basis never before remembered "making any advances as a bridge loan. This is not the bank's policy at all" (A2227).

the amount deemed prudent in Citibank's own advance instructions for 1971 (Fdg P269).

On each occasion, however, *Citibank only granted the over-advances on the condition that Topper effect the Private Placement and remit its proceeds to Citibank* (Fdgs P275, P281 and P288). As admitted by a Citibank officer responsible for Topper on a daily basis, Citibank " 'went along at this time' " with Topper's requests for over-advances only because it knew the " 'debenture money' was coming in" (Fdg P288). The Court found that *without these bridge loans, Topper would have been unable "to continue operations during the summer of 1971"* (Fdg P193) (emphasis added).

III.

The Fact That Information Sought From, and Possessed by, Citibank Might Have Been Procured From Other Sources Is No Defense to the Misstatement and Concealment of Facts Actually Known by Citibank.

Likewise without merit is Citibank's position that the Pension Fund's failure to secure and itself wade through, distill and analyze Topper's voluminous reports on collections and receivables disables any claim of fraud against Citibank, even though Waldman himself had the same information summarized before him at the time of his favorable report; or that the Pension Fund's questions to Waldman were not as adroit as a Citibank officer, versed in the complex of Topper's reports on receivables and collections, might himself have fashioned.

A similar claim that sophisticated investors[11] failed to " 'make reasonable investigations to discover the informa-

[11] The "Exchange Act is not intended to provide protection only for uninformed or unsophisticated investors. . . . The protections and remedies of that Act are not limited to the gullible and unwary for 'Fraud may

tion claimed omitted by defendant' " was rejected in *Stier* v. *Smith*, 473 F.2d 1205, 1208 (5th Cir. 1973) where the Fifth Circuit reasoned:

> "We should always be wary of holding that a purchaser of securities, who deals with the corporate insider, could have found out omitted material facts by examining the corporate books or undertaking other extensive investigations. To do so is to allow the insider to present prospective purchasers with a mountain of information which they cannot possibly digest and excuse themselves from liability on the basis that they did not provide the right answers because they were not asked the right questions." (Footnote omitted.)

In short, even if plaintiffs could have learned the truth by themselves wading through the mountain of Topper's records which Citibank was paid to digest and analyze each day (*see* Fdgs P210-P212), that fact would not suffice to excuse Citibank from liability because "[a]vailability elsewhere of truthful information cannot excuse untruths or misleading omissions" on the part of Citibank. *Dale* v. *Rosenfeld*, 229 F.2d 855, 858 (2d Cir. 1956). *See Metro-Goldwyn-Mayer, Inc.* v. *Ross*, 509 F.2d 930, 937 (2d Cir. 1975). As *Holdsworth* v. *Strong*, 545 F.2d 687, 692 (10th Cir. 1976), observed, once "proof of intentional misconduct" is established, "the exaction of a due diligence standard from the plaintiff becomes irrational and unrelated."

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also be perpetrated upon the powerful and the sophisticated.' " *Carroll* v. *First National Bank*, 413 F.2d 353, 357 (7th Cir. 1969), *cert. denied*, 396 U.S. 1003 (1970). "Obviously if the plaintiffs did not possess the information . . . , they could not bring their sophisticated knowledge of business affairs to bear in deciding whether or not to invest in [the securities at issue]." *Hill York Corp.* v. *American International Franchises, Inc.*, 448 F.2d 680, 690 (5th Cir. 1971).

IV.

Hochfelder Affords No Safe Haven for Citibank.

At issue here is whether the District Court erred as a matter of law in holding that good faith is an adequate defense under the federal securities laws when plaintiffs, in a misrepresentation case involving direct personal dealing, prove that the defendant had actual knowledge of the falsity of the facts misstated and concealed.

A. Actual Knowledge of Material Facts Misrepresented or Concealed Suffices to Establish Scienter

Initially both parties agree that *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976) made clear that negligence alone is insufficient to support liability under Rule 10b-5, that *some* form of scienter must also be proved, and that an "intent to deceive, manipulate or defraud" suffices to establish scienter. *Id.* at 193. Between intent to defraud and negligence, however, a variety of mental states exist, including recklessness and, as in the case at bar, actual knowledge of facts misstated or concealed. While *Hochfelder* had no reason to address the issue of whether actual knowledge would suffice to establish scienter, subsequent case law and commentary reaffirm the rule in this Circuit and at common law that proof of "actual knowledge of falsity is amply sufficient" to establish scienter. *Heit* v. *Weitzen*, 402 F.2d 909, 914 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969); *see SEC* v. *Universal Major Industries Corp.*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 95,804, at 90,916 (2d Cir. Dec. 16, 1976); *Herzfeld* v. *Laventhol, Krekstein, Horwath & Horwath*, 378 F. Supp. 112 (S.D.N.Y. 1974), *aff'd*, 540 F.2d 27 (2d Cir. 1976).

For example, in *McLean* v. *Alexander*, 420 F. Supp. 1057 (D. Del. 1976) the defendant also placed "reliance on the defense of good faith," *id.* at 1080, and the court found that his conduct constituted "far more than mere negli-

gence, but [fell] short of a preconceived actual intent to defraud." *Id.* Imposing liability in such circumstances, *McLean* concluded:

> "I find no rational reason why actual knowledge of omitted material facts, sufficient to establish scienter in non-disclosure cases, is not equally sufficient in this case of misrepresentation where defendant has knowledge of either the actual misrepresentation or the material omissions. *Accordingly, I find the requisite scienter essential to liability under 10(b) and Rule 10b-5 is present in the form of knowing misconduct, in that Schiavi had actual knowledge of material facts which he failed to disclose in his opinion audit.*" *Id.* at 1082 (emphasis added) (footnote omitted).

In sum, though time has been short and relevant decisions therefore sparse since *Hochfelder*, "there has not been any inter-Circuit controversy that *scienter* short of specific intent to defraud is sufficient to support liability." *Sundstrand Corp.* v. *Sun Chemical Corp.*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 95,887, at 91,259 n.16 (7th Cir. Feb. 23, 1977). "Under *Ernst & Ernst*, an allegation of actual knowledge is sufficient. . . . even under the most strict view of the scienter requirement." *Raskas* v. *Supreme Equipment & Systems Corp.*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 95,694, at 90,428 (E.D.N.Y. Aug. 2, 1976); *see Weinberger* v. *Kendrick*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 95,853 (S.D.N.Y. Jan. 24, 1977); Bucklo, *The Supreme Court Attempts to Define Scienter Under Rule 10b-5: Ernst & Ernst* v. *Hochfelder*, 29 Stan. L. Rev. 213, 219 (1977).[12]

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[12] Not inconsistent with such authority is *Franklin Savings Bank* v. *Levy*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 95,902 (2d Cir. Mar. 9, 1977), which reversed a Section 10(b) finding because, unlike here, the district court failed to consider the scienter issue. In support of its conclusion that scienter was not considered the Second Circuit panel noted that evidence which bore on the materiality of facts omitted as well as on "the good faith *vel non* of Goldman, Sachs" was improperly excluded.

B. Citibank Possessed Actual Knowledge of Material Facts Concerning Topper's Financial Condition Which Its Favorable Report to the Pension Fund Misrepresented or Concealed

The District Court found, to repeat, that on August 27, 1971 Citibank's Waldman "called the Pension Fund . . . and gave a favorable report on Topper's current financial condition" (Fdg P20). Specifically, the Court found that "Citibank represented to the Pension Fund [1] that Topper had performed well in a Citibank audit of its receivables, [2] that Topper's principal product line was faring well at retail, [3] that there were no current problems with the Topper account and that Citibank anticipated none" (Fdg P20).

On cross-examination, however, Waldman was forced to admit personal knowledge contrary to each of the specific representations he made to the Pension Fund:

(1) "Q. I call your attention next to Plaintiffs' Exhibit 621, which is the Citibank advance sheet bearing the date August 26, 1971. You see your initials on it?

"A. Yes, I do.

* * * * *

"Q. That advance sheet shows receivables more than 60 days past due totalled $9,536,812?

"A. Yes.

"Q. That advance sheet shows that in addition to those receivables more than 60 days past due, there were $3,587,693 worth of receivables that were ineligible?

"A. Yes, it does.

Id. at 91,358. In the case at bar, by way of contrast, all parties were given ample opportunity to make their case, no significant evidence was excluded, and those facts which Citibank knew about Topper, compared to what it told the Pension Fund, stand proved. *Franklin Savings,* which was a non-disclosure as opposed to a direct misrepresentation case, nowhere intimated that "good faith" was a defense available to a party who has actual knowledge of the falsity of *explicit* misrepresentations which he made to plaintiffs. *See infra* at 17-19.

"Q. Were you aware as of August 26, Mr. Waldman, that as of the end of June receivables more than 60 days past due were just over $3 million?

"A. Yes.

"Q. And that now in August they had gone up 300 percent, more than $9 million?

"A. Yes, I testified earlier to that on that same subject" (A1392-A1394);

(2) "Q. You initialed this on August 27, did you, this advance sheet, Plaintiffs Exhibit 621?

"A. Yes.

"Q. As of August 27 you said you knew that Dawn was a principal Topper product for 1971?

"A. Right.

* * * * *

"Q. You knew that Topper had reported to you in July that customers were not selling Dawn as they projected earlier in the year? You knew that?

"A. Yes" (A1393-A1394);

(3) "Q. You knew that Topper's cash collections was substantially below their projections?

"A. Yes.

"Q. You knew that twice before August 27, in six weeks, the bank had amended its finance agreement to permit over-advances?

"A. Right.

"Q. You knew as of August 27 receivables more than 60 days past due were in excess of $9 million?

"A. Right.

"Q. You also knew the total amount of receivables outstanding?

"A. Right.

"Q. They were $30 million?

"A. Yes.

"Q. So 30 percent of the total receivables were more than 60 days past due?

"A. Right.

"Q. And another 10 percent were otherwise ineligible?

"A. Yes.

"Q. You testified that was the day you called Thompson, August 27?

"A. If that is what my testimony shows, yes.

"Q. I think that what you said" (A1394-A1395).

C. Good Faith Is No Defense in Light of Citibank's Actual Knowledge

With actual knowledge established, there is no room for a good faith defense in a misrepresentations case under the securities laws. Though elusive,[13] good faith is generally used, when actual knowledge is absent, to refer to a diligent effort to learn the facts. While various provisions of the securities laws provide that defendants who misstate or conceal material facts may avoid liability by showing they acted in good faith, or exercised due diligenge, they may do so if, *and only if,* they also prove the absence of actual knowledge of material facts misstated or omitted.[14] Significantly, it was in the context of an accounting firm who made a "good faith" or diligent effort to uncover the facts that the good faith reference in *Hochfelder* arose.

Similarly, legislative history relied upon in *Hochfelder* makes clear that actual knowledge suffices for scienter. Thus the Court cited to the Senate Committee Report on

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[13] Appropriately described as a term equally elusive as its opposite, bad faith, both terms "remain cherished resorts of lawyers (and sometimes of judges) who have little else to conjure with." 2 A. Bromberg, *Securities Law* § 8.4 (561) at 204.204 (1975).

[14] *See, e.g.,* § 11 of the 1933 Act, 15 U.S.C. § 77k ("no reasonable ground to believe . . . that the statements therein were untrue"); § 12 of the 1933 Act, 15 U.S.C. § 77*l* (defendant "did not know, and in the exercise of reasonable care could not have known"); § 15 of the 1933 Act, 15 U.S.C. § 77*o* ("unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts"); § 18 of the 1934 Act, 15 U.S.C. § 78r ("unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading").

what became the Securities Exchange Act of 1934, particularly the language:

> "'In such case, the burden is on the plaintiff to show the violation or the fact that the statement was false or misleading, and that he relied thereon to his damage. The defendant may escape liability by showing that the statement was made in *good faith.*' S. Rep. No. 792, *supra,* at 12-13 (emphasis supplied)." 425 U.S. at 206.

This legislative history, however, which was relied upon by the Court to demonstrate that negligence was insufficient, refers not to § 10(b), but to § 18 of the 1934 Act, which treats false filings with the Securities and Exchange Commission, and specifies liability "unless the person sued shall prove that he acted in good faith *and had no knowledge that such statement was false or misleading.*" 15 U.S.C. § 78r(a) (emphasis added).[15] It follows, then, that "[i]f actual knowledge is found, good faith is of course negated." Bucklo, *Scienter and Rule 10b-5,* 67 Nw. U. L. Rev. 562, 570 n.35 (1972).[16] Confirming this view, the Seventh Circuit recently ruled that "good faith is not appropriate as a defense to reckless or intentional behavior." *Sundstrand Corp.* v. *Sun Chemical Corp.,* [Current] Fed. Sec. L. Rep. (CCH) ¶ 95,887, at 91,259 n.17 (7th Cir. Feb. 23, 1977); *see McLean* v. *Alexander,* 420 F. Supp. 1057, 1081 (D. Del. 1976).

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[15] *SEC* v. *Texas Gulf Sulphur Co.,* 401 F.2d 833, 862 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969), rejected good faith as a defense under Rule 10b-5 unless the defendant "demonstrates that it was diligent in ascertaining that the information it published was the whole truth . . . ."

[16] This article was cited with approval by *Hochfelder* to demonstrate that scienter, not negligence, was the standard required by Section 10(b). Significantly, Bucklo concluded that "*scienter* should be interpreted to mean knowledge of the facts," 67 Nw. U. L. Rev. at 570, and this applies to defendants, such as Citibank here, who had "known of the falsity of the statements b[illegible]ped that, with additional experimentation, the material would be sui[illegible]e." *Id.* at 568.

When used in the context of a defendant having actual knowledge of the falsity of his misstatements and omissions, as in the case at bar, good faith can only mean the lack of evil motive or wicked intent.[17] This much, however, neither a civil plaintiff nor the Government in a criminal proceeding under the securities laws is required to prove. *See Appellants' Brief* at 24-25. For these reasons, then, whatever Waldman's purpose or motive for misstating or concealing material facts actually known to him might have been, scienter follows as a matter of law.

D. In Any Event, the District Court's "Good Faith" Finding Does Not Follow From the Facts on Which It Rests

The District Court found that "Waldman acted in good faith in his conversation with Thompson" (A27). Amplifying the basis for this conclusion, however, the Court explained that what it meant was that if Waldman's superior at Citibank had asked Waldman about "any problems in Topper in 1971 he would have answered the same way as to Thompson" (A1557); "it would seem to me to follow as a matter of law that the Fund was entitled to nothing better" (A1536). And the District Court made clear that by "superior" he meant an officer "asking [Waldman] the question from the point of view of a secured lender" (A1557-A1558).

Even assuming Waldman would have answered questions never asked by his superior as he did in fact answer questions put by Thompson, and even assuming any such response to a superior would have been in good faith, the perspective of the parties in late August was sufficiently different that an answer adequate for one person—*viz.*, a secured lender counting on an influx of more than $5 million in unsecured funds--was far from adequate for the

[17] Tending to support that this was the sense in which the Court used the term "good faith" is its parallel finding that neither Waldman nor Citibank "had any conceivable *motive* to mislead Thompson or the Fund" (A27-A28) (emphasis added).

purposes of a party considering whether to provide those unsecured funds.

Thus accepting that on August 27, 1971 Waldman believed that Topper was "still a good credit" (A1409) from Citibank's point of view,[18] he nonetheless misled the Pension Fund, who he knew was considering an unsecured convertible investment, by proffering a favorable report without mentioning the material facts which qualified that report, including *inter alia,*

- that Citibank had protected itself against the rapid deterioration in Topper's receivables by refusing to lend against nearly 50% of the receivables (Fdg P264), the only asset deemed worthy for advances by Citibank in 1971 (Fdgs P245-P246); and

- that the Bank safeguarded its own capital by conditioning 25% of the total current advances on

[18] In support of its position that Topper was a "good credit" at the time Waldman gave his favorable report to the Pension Fund, Citibank, relying on figures from Topper's 1971 unaudited financial statements, which the District Court found to be false and misleading (Fdg P173), claims that the Topper account was "more than adequately collateralized" (*Appellee's Brief* at 45). However, while Topper's assets at the end of August had an assigned book value of $49.8 million (A3792) compared with a $20.7 million outstanding loan, the so-called "excess collateral" was, as Citibank well knew, illusory because it included, *inter alia,* $14 million of receivables currently deemed past due or ineligible (A2413); $2.2 million in redated receivables (A132) which Citibank believed were "not entitled to the same credit worthiness" as other receivables (A1997); $5.6 million in warehouse receivables (A136) which Waldman himself viewed as "meaningless from the point of view of . . . insuring us that the customer would pay" (A2355); $9 million of current receivables which, in light of the deterioration in past dues and the substantial amount of returns, were subject to comparable dilution in the future (Fdg P183; A1459); $11.5 million of inventory comprised basically of the same product line, namely Dawn (A1238), which had been oversold at retail for at least the last eight months (Fdgs P168-P170); $3.7 million in Topper machinery and equipment, the value of which had not been independently appraised since 1967 (A3648; *see* A1183) and was thus substantially limited for collateral purposes (A1454-A1455); and $2.4 million of molds and dies (A2672) whose value to a secured lender "cannot be considered to be worth anything" (A1456).

Topper's ability to effect the Private Placement and remit its proceeds back to the Bank (Fdgs P275, P281, P288).

Citibank's Mr. Siegel was quite frank in admitting that Citibank only "went along" with the $5 million bridge loan because it knew the "debenture money" was coming in (Fdg P288) and further acknowledged that the sole source of Citibank's comfort with regard to its secured loan prior to September 28, 1971 was the fact that "unsecured" funds "would come in below the line to protect" the Bank (A1501). Confirming that it was these steps which in fact gave comfort to Citibank, in the twelve-day period from September 17 to September 29, Citibank's own share of the outstanding Topper loan was reduced by $5.3 million (Fdg P295), all of which prompted a Citibank auditor to remark soon after the Private Placement, "Good to see our loan down" (A3236). The District Court concluded that, "[A]s a result of the Private Placement the Topper loan was again more than adequately secured by collateral—*viz.*, from a $5 million over-advance on August 27, 1971, Citibank's record showed a cushion of almost $5 million in unused and eligible collateral on September 29, 1971 (CB ADM 219). Despite this substantial cushion," according to Waldman, "Citibank had no intention 'to increase the loan balances at all' beyond this point" (Fdg P294).

This was all well and good for Citibank, but by failing to reveal the material facts which qualified his favorable report to the Pension Fund—facts which spelled trouble for an unsecured lender but which might well give comfort to a bank superior—Waldman spoke only half the truth. The law is clear, though, that "one who undertakes to make statements under circumstances such as this, is bound not only to state truly what he tells, but also not to suppress or conceal any facts within his knowledge which materially qualify those statements." *Mid-States Insurance Co.* v. *American Fidelity & Casualty Co.*, 234 F.2d 721, 729 (9th

Cir. 1956). *See Appellants' Brief* at 21-22. In short, knowing what he admitted he knew, and having agreed to speak at all, Waldman left the Pension Fund with "the impression that all was serene when he knew there was a significant risk of trouble" for an unsecured investor. This Waldman on behalf of Citibank "could not do consistently with the securities laws." *SEC* v. *Geon Industries, Inc.*, 531 F.2d 39, 50 (2d Cir. 1976).

Dated: April 6, 1977

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UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

UNITED STATES STEEL AND CARNEGIE PENSION FUND, INC., CONNECTICUT MUTUAL LIFE INSURANCE COMPANY, et al.,	:	
Plaintiffs-Appellants,	:	AFFIDAVIT OF SERVICE ON PERSON IN CHARGE
-against-		
HENRY ORENSTEIN, FIRST NATIONAL CITY BANK, HAYDEN STONE INC., et al.,	:	
Defendants,	:	No. 76-7528
-and		
FIRST NATIONAL CITY BANK,	:	
Defendant-Appellee.	:	

STATE OF NEW YORK)
: ss.:
COUNTY OF NEW YORK)

Henry McGin being duly sworn, says: I am employed in the office of Breed, Abbott & Morgan, 1 Chase Manhattan Plaza, New York, N.Y. 10005, attorneys for the Plaintiffs-Appellants in the above action.

On the 6th day of April 1977, I served the annexed REPLY BRIEF OF PLAINTIFFS-APPELLANTS

on the attorney(s) listed below by delivering the same to and leaving the same with the person in charge of said office(s).

Shearman & Sterling, Esqs., Attorneys for Defendant-Appellee,
53 Wall Street, New York, New York 10005

Sworn to before me this
6th day of April, 1977

Donald L. Price

DONALD L. PRICE
NOTARY PUBLIC, State of New York
No. 24-6429360
Qualified in Kings County
Certificate Filed in New York County
Commission Expires March 30, 1978

Henry McGin